

CALIFORNIA STATE BOARD OF EQUALIZATION

APPEALS DIVISION SUMMARY FOR BOARD HEARING

In the Matter of the Administrative Protest)
Under the Sales and Use Tax Law of:)
ZOGRAB KYABABCHYAN, dba) Account Number: SR AC 100-244251
Maple Liquor) Case ID 472377
Taxpayer)
Burbank, Los Angeles County

Type of Business: Liquor store

Audit period: 10/01/04 - 12/31/07

<u>Item</u>	<u>Disputed Amount</u>
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Unreported sales	\$370,945
Negligence penalty	\$ 3,070
Finality penalty	\$ 3,070
Claimed refund	\$ 12,000

	<u>Tax</u>	<u>Penalty</u>
As determined and redetermined:	\$30,697.93	\$3,069.85
Finality penalty	00.00	3,069.79
Total	\$30,697.93	\$6,139.64
Less concurred	- 94.88	00.00
Balance, protested	<u>\$30,603.05</u>	<u>\$6,139.64</u>
Redetermined tax	\$30,697.93	
Interest through 6/30/10	9,806.49	
10% penalty for negligence	3,069.85	
10% finality penalty	3,069.79	
Total tax, interest, and penalty	\$46,644.06	
Payments	<u>-17,000.00</u>	
Balance Due	<u>\$29,644.06</u>	

Monthly interest beginning 7/1/10 \$ 79.90

UNRESOLVED ISSUES

Issue 1: Whether adjustments are warranted to the audited amount of unreported sales. We recommend no adjustment.

Taxpayer has operated a liquor store since May 2003. In its initial review of the records, the Sales and Use Tax Department (Department) used taxpayer's paid bills to compute taxable purchases, which exceeded taxpayer's reported taxable sales for 2005 and 2006. Department staff, on two

1 separate occasions, made “undercover” purchases, and taxpayer did not charge sales tax
2 reimbursement on sales of cigarettes and soda. Based on these facts, the Department concluded that
3 reported taxable sales were understated and decided to establish audited taxable sales on a markup
4 basis. The Department used taxpayer’s paid bills to compile merchandise purchases for 2005 and
5 2006. It then used paid bills for the third quarter of 2007 (3Q07) to perform a purchase segregation
6 test, which disclosed that 87.22 percent of taxpayer’s purchases represented taxable merchandise. The
7 Department applied that percentage to total purchases to establish purchases of taxable merchandise
8 for 2005 and 2006, and it accepted the amount of taxable purchases compiled by taxpayer for 2007.
9 The Department adjusted audited taxable purchases for an increase in inventory and by 1 percent for
10 pilferage losses¹ to establish the audited cost of taxable goods sold. The Department performed a shelf
11 test using costs from purchase invoices dated in July 2007 and selling prices provided by taxpayer to
12 compute markups for various merchandise categories. It then used the percentages of merchandise in
13 each category from the segregation test to compute a weighted average markup of 43.9 percent. The
14 Department found that markup to be in the high end of the range of markups expected for this business
15 (30 to 45 percent). Therefore, in order to be conservative in its computations, the Department reduced
16 the audited markup to 38 percent. The Department used the audited cost of taxable goods sold and the
17 38 percent markup to compute audited taxable sales, which exceeded reported amounts by
18 107.54 percent for the three years, 2005, 2006, and 2007. The Department applied that percentage of
19 understatement to reported taxable sales to establish the understatement at issue.

20 Taxpayer contends that the audited amount of unreported sales is excessive because his actual
21 markup is about 31 percent, and the percentage of taxable to total merchandise purchases is less than
22 the 87.22 percent computed by the Department. As support, taxpayer provided a shelf test at the
23 conference in which he compared costs from purchase invoices dated in 3Q07 and selling prices that
24 he recalled from that period. Taxpayer has not provided documentation, such as cash register tapes, to
25 support the selling prices used in his shelf test. Regarding the audited percentage of taxable to total
26 purchases, taxpayer asserts that the Department’s purchase segregation test failed to account for

27 _____
28 ¹ The Department did not make an adjustment for self-consumption because taxpayer stated there was none.

1 purchases of phone cards from Global Connect Telecommunications (Global). Taxpayer has provided
2 a letter from Global stating the total amounts of purchases for 2005, 2006, and 2007.

3 With respect to the markup, according to taxpayer, he prepared his shelf test in May or June
4 2009, using selling prices as he remembered them for the third quarter 2007, almost two years earlier.
5 We find that the selling prices from taxpayer's memory are significantly less reliable than the prices
6 provided to the Department during the audit, and used in the Department's shelf test. For that reason,
7 we reject taxpayer's shelf test. Also, we note that the Department has arbitrarily reduced the markup
8 computed in the shelf test, 43.9 percent, to 38 percent. We conclude that this reduction amply
9 compensates for any inaccuracy in the test, and note that the resulting markup of 38 percent is well
10 within the range of markups we would expect for this business, 30 to 45 percent. We find there is no
11 basis for further adjustment of the audited markup. Regarding the audited percentage of taxable to
12 total merchandise purchases, the Department states that no adjustment is warranted for purchases of
13 phone cards from Global because phone cards were neither included in the purchase segregation test
14 nor included in the total amounts of purchases to which the 87.22 percent was applied. We have
15 reviewed the audit workpapers and conclude the Department is correct. Therefore, while an
16 adjustment for purchases of phone cards would reduce the percentage of taxable to total merchandise
17 purchases, the lower percentage would be applied to a greater amount of total purchases, and the result
18 should be just about the same. We find that the Department used an appropriate procedure, excluding
19 phone cards from its computation of both the percentage of taxable to total merchandise purchases and
20 the total amount of purchases, and that no adjustment is warranted for this contention.

21 **Issue 2:** Whether taxpayer was negligent. We conclude that he was.

22 The Department imposed the 10-percent penalty for negligence because reported taxable sales
23 were less than audited purchases of taxable merchandise, and the understatement is large in relation to
24 the reported measure of tax. Taxpayer disputes the penalty on the basis that he does not think the
25 understatement was the result of negligence. Taxpayer also notes that the manager of the business
26 (who is taxpayer's brother) left the business in early 2009, and taxpayer may have made errors because
27 he does not know how to run the business.
28

1 Taxpayer did not provide cash register tapes from the audit period, a sales journal, or
2 worksheets showing how the amounts reported on the sales and use tax returns were computed. He
3 provided purchase invoices, but no purchase journal. Thus, he did not provide the normal books of
4 account ordinarily maintained by a prudent businessperson engaged in this type of business. Further,
5 while taxpayer estimates that his markup was 31 percent, he did not report tax on his cost of taxable
6 merchandise plus 31 percent, consistent with his assertion. Rather, his reported taxable sales were less
7 than audited purchases of taxable merchandise. That discrepancy should have alerted taxpayer to the
8 errors in reporting. Moreover, the amount of unreported taxable sales of \$370,945 represents a
9 percentage of error of 107.54 percent in comparison to reported taxable sales of \$344,943. Thus,
10 taxpayer reported less than half of his taxable sales. We find that the incomplete records, the large
11 amount of understatement, and the substantial percentage of error in comparison to reported amounts
12 to be evidence that taxpayer did not exercise due care in recordkeeping or reporting. Thus, we
13 conclude the understatement was the result of negligence, and the penalty was properly applied. With
14 respect to taxpayer's assertion that he made errors because he was inexperienced in business and the
15 manager of the business left, we note that the manager left in 2009, well after the end of the audit
16 period (December 31, 2007). Thus, we find that the manager's departure is not relevant to the question
17 of whether taxpayer was negligent. In any event, the state of the records and the size of the error
18 warrant upholding the negligence penalty without regard to when the manager departed.

19 **Issue 3:** Whether relief of the finality penalty is warranted. We find no basis for relief.

20 The finality penalty was applied because taxpayer did not pay the determination or file a
21 petition for redetermination within the 30-day period following the date the Notice of Determination
22 was issued. Taxpayer has requested relief from the penalty on the grounds that he did not receive that
23 notice.

24 The Notice of Determination was mailed to taxpayer's address of record, and it was not
25 returned by the Post Office. Further, taxpayer's assertion that he did not receive the notice is
26 inconsistent with statements made by taxpayer's representative at the conference. We conclude that
27 taxpayer did receive the Notice of Determination, and that his failure to file a timely petition or pay the
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determination was not due to reasonable cause or circumstances beyond his control. Thus, we find no basis upon which to recommend relief of the finality penalty.

Issue 4: Whether the claim for refund filed December 10, 2009, should be granted.

As of April 22, 2009, taxpayer has made several payments, two of which were for \$500, and the remainder of which were for \$1,000 each. Taxpayer filed a claim for refund of \$12,000.00 on December 10, 2009, which is timely for \$6,000.00 paid during the period June 10, 2009, through December 10, 2009.²

For the reasons explained under Issue 1, we find there is no overpayment, and we recommend the claim for refund be denied.

OTHER DEVELOPMENTS

None.

Summary prepared by Deborah A. Cumins, Business Taxes Specialist III

² In general, a claim for refund is timely if filed within three years from the date the return was due or, with respect to determinations, within six months from the date the determination becomes final or six months from the date of payment, whichever period expires later. The determination here was issued July 10, 2008, and became final on August 9, 2008. As of April 22, 2010, taxpayer has paid \$17,000.00 which has fully paid the total amount of tax determined for the period October 1, 2004, through June 30, 2006 (\$14,916.80), and has paid \$2,083.20 of the \$2,361.98 determined for the third quarter 2006. The three-year period with respect to the most recent of those periods, the third quarter 2006, ended October 31, 2009, and the six-month period following the date the determination became final ended February 9, 2008, and both of those dates were prior to the date of the claim for refund. Therefore, the claim is timely only for the payments made within the six months prior to December 10, 2009, which total \$6,000.00.

MARKUP TABLE

Percentage of taxable vs. nontaxable purchases	87.22%
Mark-up percentages developed	38%
Self-consumption allowed in dollars	None*
Pilferage allowed in dollars	\$6,006 for the three years 2005, 2006, & 2007
Pilferage allowed as a percent of total purchases	1%

* Taxpayer stated that there was no self-consumption.